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C O N F I D E N T I A L SECTION 01 OF 02 MOSCOW 000508

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SUBJECT: RUSSIAN ENERGY: SHELL TALKS ABOUT SAKHALIN-2

REF: 06 MOSCOW 12930

Classified By: Econ M/C Pamela Quanrud. Reasons 1.4 (b/d).

11. (C) Summary: On January 25, we met with Alf D'Souza, Shell's External Affairs VP, and Bibi Bautleuova, a Shell government affairs rep, to talk about the Sakhalin-2 deal that Shell and its partners (Japan's Mitsubishi and Mitsui) reached last month with Gazprom. D'Souza said that they got the best deal they could have hoped for under the circumstances. Three agreements were signed regarding the project: two with Gazprom -- one on the sale of the stake and another in which the companies agreed to work jointly on the future development of Sakhalin-2 (and possibly other projects). The third agreement was with the GOR to set up a joint commission to approve Sakhalin-2's budget. The GOR's environmental concerns with the project were fading fast and should be wrapped up shortly, and Shell is still interested in the EXIM/EBRD/JBIC/ECGD loan package. Putin was "very upset" about the cost overruns and that, as a result of their performances, Ministers Khristenko and Trutnev as well as Gazprom's Aleksandr Medvedev likely improved their standing within the GOR energy policymaking community. Shell will continue to play a significant role in the project, partially dispelling worries that Gazprom's entry would be a disruptive influence. End Summary.

The Deal

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12. (C) D'Souza said Shell views the outcome as essentially the best deal they could possibly have hoped for under the circumstances, and not a bad deal even on its own merits. The \$7.5 billion price tag values the company at \$15 billion -- not far from the \$13 billion already spent for a project that's about 80-85 percent completed. For its \$7.5 billion, Gazprom will get 50% plus one share. The deal is in a purely mechanical stage now and should close by March. In addition, Sakhalin Energy Investment Company (SEIC), the developer of the project, will still have seven directors, with Gazprom appointing four and Shell three. Gazprom's new stake will come from the other partners in proportion to their previous holdings (Note: Shell previously owned 55 percent, Mitsui 25 percent, and Mitsubishi 20 percent).

13. (C) D'Souza assured us that, by virtue of SEIC's

governance structure, the western investors will maintain control over important decisions, such as contracting out for services. Further, he said Gazprom will not be "carried" -- they will pay their share of future expenses -- and Shell will remain "technical advisor" to SEIC. Shell believes Gazprom is very happy with this situation, and acknowledges that, at least for now, it does not have any LNG expertise.

#### Approving the Budget and Moving Forward

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14. (C) Shell also reached agreement with the GOR on setting up a mechanism to work on the current budget -- and the cost overruns -- and approve the consortium's next budget. D'Souza said that the budget will be vetted by an interagency commission of interested GOR entities, including the Ministries of Natural Resources, Industry and Energy, and Economic Development and Trade. Through this commission, SEIC has been told in no uncertain terms that about \$3.6 billion of its previous "cost overruns" are not allowable. However, the way the payback is structured the net present value of the cost to SEIC will be only about \$200-\$300 million.

15. (C) SEIC and Gazprom also signed an agreement on Areas of Mutual Interest, on which they will work together in the future regarding Sakhalin-2. D'Souza speculated that this, for example, could mean bringing other sources of gas into the Sakhalin-2 export chain or step-out drilling within the license block. This deal could be "a relationship that could lead to other things, but that they (Shell) weren't getting carried away."

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#### Environmental Problems Fade

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16. (C) D'Souza expects the GOR's environmental concerns to disappear soon. He believes Shell's liabilities for all the alleged violations that have filled the news in recent months will be low. This is a convenient face-saving way for the GOR to close down the drama of recent events. Already the pressure is abating -- the Lunskeye drilling permit was recently issued, visa issues for their workers are being resolved, and water permits are back in force.

#### MDB Loan Package

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17. (C) D'Souza indicated that SEIC is still very interested in the Exim/EBRD/JBIC/ECGD loan package. Unlike the news coverage suggesting that EBRD has canceled consideration of the loan, SEIC considers it merely in limbo and expects that it will be dusted off and revisited after the dust from the deal with Gazprom settles.

#### Politics in the Rear-View Mirror

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18. (C) On the political front, D'Souza admitted that Putin became upset at the cost over-runs and personally became involved in authorizing the GOR to go after SEIC. (Note: This is the first time we have heard this from a Shell executive here, although we have heard it from others in the know for some time. End Note) A major problem, however, was that Putin's sources of information were so narrow (basically just Gazprom) that he could never make an accurate judgment about the over-runs. D'Souza said that the Ministry of Economic Development and Trade, for example, was shocked when shown Shell's economic model because it was so significantly different than their own (developed, we think, by Gazprom) and showed such different conclusions.

19. (C) Our Shell counterparts pointed out who they felt were the GOR's winners in the aftermath of this crisis. Energy

Minister Viktor Khristenko comes out looking pretty good for having come in at the end to close the deal, and Natural Resources Minister Yuriy Trutnev's standing has increased for having "looked out for the interests of the state." In addition, Aleksandr Medvedev, Deputy CEO of Gazprom and head of Gazexport, proved that he is a real player in the energy world here, having done much of the negotiating for the Russian side.

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[¶](#)10. (C) Gazprom's recent assurances that contracted LNG shipments will go forward, apparent acquiescence to Shell's continued role as operator, admittal of its technological shortcomings, and willingness to pay a relatively fair price for its stake suggest that the state's advent into the project may not herald either significant delay or complicate Russia's entry into the global LNG market. While the strong-arm tactics used to secure its spot in Sakhalin-2 showed Gazprom's clout, Shell admits it is probably a good thing to have Gazprom as a partner and indeed had been courting Gazprom for such a role for several years. With this deal, Putin and his closest advisors are one step closer to putting in order those inheritances from the 1990s that they perceive as unjust or (in the case of the cost over-runs) abusive.  
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